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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966.

No. 768

WILLIAM J. SULLIVAN AND
GEORGIA K. SULLIVAN,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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To The Honorable, The Chief Justice and The Associate Justices of The Supreme Court of The United States:

The petitioners, William J. Sullivan and Georgia K. Sullivan, by their counsel, pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit.

OPINIONS BELOW

The opinion of the United States District Court entered June 29, 1965, is reported at 244 F. Supp. 605.

The opinion of the Court of Appeals for the Eighth Circuit entered August 3, 1966, is reported at 363 F. 2d 724.

The opinion of the District Court is reprinted in the appendix hereto (Appendix B, *infra*, p. A16). The opinion of the Court of Appeals for the Eighth Circuit is contained in the Record, p. 1.

JURISDICTION

The judgment of the Court below was entered on August 3, 1966 (R. 10). Upon a timely motion the Court below extended the time for filing a Petition for Rehearing to September 2, 1966. A timely Petition for Rehearing was denied on September 15, 1966 (R. 32). A timely Renewed Petition for Rehearing was denied on October 31, 1966 (R. 45).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

QUESTIONS PRESENTED

1. Whether, when the corporation purchased the shares of stock of one of its shareholders (Nelson), and another shareholder (Sullivan) was bound by an executory contract to purchase at book value; has the corporation thereby distributed income as defined in the Sixteenth Amendment to Sullivan, where Sullivan admittedly received neither money nor property?

2. Whether, in a Federal tax case, the substance of the transaction is controlling, so that courts should consider motives, intent, and conduct in addition to written instruments.

3. Whether, since the subject transaction also constituted a partial liquidation of the corporation, there could be a dividend to petitioners by reason of Sections 346 (b) and 331, Internal Revenue Code of 1954.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Constitution of The United States, Sixteenth Amendment (Appendix A, *infra*, p. A1).

Constitution of The United States, Fifth Amendment (Appendix A, *infra*, p. A1).

Section 115, Internal Revenue Code of 1939.

Section 301[1] (Appendix A, *infra*, p. A2).

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Treasury Regulations, Internal Revenue Code of 1954:

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Sec. 1.346-2.

Rev. Rul. 58-614, C.B. 1958-2, p. 920.

Rev. Rul. 59-286, C.B. 1959-2, p. 103.

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1. Unless otherwise indicated, all references are to the Internal Revenue Code of 1954.

STATEMENT

This case originated with the filing of a complaint by petitioners, William J. and Georgia K. Sullivan[2] in the United States District Court for the Western District of Missouri (which had jurisdiction under Section 1346 (a) (1), Title 28 U.S.C.), to recover Federal income taxes and interest erroneously assessed and collected by the respondent (R. 1, 10).

The case was initiated by the District Director's determination that petitioner received a dividend by reason of a corporation's redemption of shares of stock from another shareholder (R. 84). An income tax assessment of $203,218.44, plus interest and costs, is in dispute (R. 85). The District Court dismissed petitioner's complaint with prejudice (Appendix C, *infra*, p. A51). Said judgment was affirmed by the Court of Appeals for the Eighth Circuit (Appendix C, *infra*, p. A52).

Sullivan was an automobile dealer with dealerships in Missouri and Kansas (R. 18, 19, 36). In 1941 Sullivan purchased a Chevrolet dealership in Blytheville, Arkansas, and organized a corporation to operate it, which is the corporation involved herein (R. 19, 85). The corporation issued a total of 300 shares of common stock, all that was ever issued (R. 86). The corporation hired a manager (Eich) in 1941 who served until 1948. During this period Eich purchased stock of the corporation from Sullivan, ultimately acquiring 120 shares (R. 20). By contract Sullivan was obligated to purchase Eich's stock if the latter's

2. Georgia K. Sullivan is involved only because a joint income tax return was filed; consequently, hereinafter references to "petitioner", the "taxpayer", or "Sullivan" apply only to William J. Sullivan.

employment by the corporation was terminated (R. 20). In February, 1948, Eich resigned his position with the corporation, Sullivan purchased his 120 shares of stock for $570.00 per share, and Sullivan became the owner of all the corporation's stock (R. 20, 86, 21, 26, 87). Sullivan did not want to be obligated to redeem another corporate manager's stock (R. 23).

In February, 1948 the corporation hired Nelson as manager to replace Eich, and Nelson was permitted to purchase some of the corporation's stock under a contract executed in September, 1948 by Nelson, the corporation, and Sullivan (R. 21, 47, 48, 57, 23, 49, 95, 99). Nelson signed the contract on September 10, 1948, and the corporation adopted and ratified the contract on that date (R. 23, 24, 25, 49, 50, 52). Sullivan signed the contract on September 14, 1948 (R. 24, 50, 95, 101).

The crucial provisions of the contract are: (1) Nelson was enabled to purchase up to 40 per cent of the corporation's stock, (2) Nelson could not mortgage, transfer, or sell his stock to anyone other than Sullivan or whomever Sullivan directed in writing, and (3) Sullivan agreed, within 30 days after an offer, to accept the offer to sell said shares of stock. By execution and adoption of the contract, the parties intended to provide for: (1) the sale by Sullivan to Nelson of part of the corporation's stock, and (2) the redemption by the corporation of Nelson's stock, if his employment by the corporation was terminated (R. 23, 24, 25, 26, 41, 42, 52, 53, 59, 60, 63, 64). The contract was executed to provide a manager for the corporation (R. 21, 47, 48, 95, 96, 99, 100). Nelson's right to buy and hold the stock depended upon his capacity to act as the corporation's manager (R. 99, 100).

Nelson paid $570.00 per share for the initial block of stock he purchased from Sullivan, which was the same

price Sullivan had paid Eich (R. 26, 27, 51). From February of 1948 through April, 1956, Nelson was the corporation's manager; and periodically purchased stock of the corporation from Sullivan until he ultimately owned 114 shares, about 38 per cent of the corporation's outstanding stock (R. 21, 47, 48, 109, 110, 111, 26, 27, 51, 87, 27).

In each year during the period 1948 through 1955, the corporation paid a cash dividend to its shareholders (R. 88).

Upon formation in 1941 the corporation was primarily engaged in the sale and servicing of new and used automobiles. By February of 1948, the corporation was also engaged in financing operations, and thereafter expanded this department of its business (R. 27, 155).

In late 1955, Nelson advised the corporation that he wanted to acquire his own automobile dealership, and in February of 1956 obtained an option to purchase a Chevrolet dealership located in another city (R. 27, 28, 53). The corporation's directors concluded that it was not possible to obtain a manager (to replace Nelson) acceptable to General Motors, with the necessary experience, and with sufficient capital to purchase Nelson's stock (R. 28, 29, 101, 102, 37, 38, 39, 40). Consequently, the directors decided to sell the operating assets of the automobile dealership to whoever received the Chevrolet franchise (from General Motors) in Blytheville, Arkansas; and continue the corporation only as a finance company (R. 101, 102, 29, 68, 69, 111). Sullivan directed in writing that Nelson offer his shares of stock to the corporation (R. 108).

In April, 1956, the corporation sold the operating assets of the automobile dealership, at book value, for cash in the approximate amount of $100,000.00; the corporation continued only as a finance company, and is in that business today (R. 32, 80, 81, 39, 33). The corporation accepted

Nelson's offer, and on May 1, 1956 paid Nelson $198,334.58 for his shares of stock which became treasury stock and has never been reissued (R. 88, 41-44, 68). Nelson's employment by the corporation was terminated (R. 55, 56). The per share book value of the corporation's stock—before and after the redemption—was the same, by reason of the corporation's payout to redeem Nelson's stock (R. 154).

The value of Sullivan's interest in the corporation was the same after the stock redemption and partial liquidation as before (R. 154; Ct. of Appeals Opinion, p. 8). Sullivan received no part of the payments made by the corporation in redemption of Nelson's stock (R. 55, 35, 154). At the time Nelson's stock was redeemed, no consideration was given to the tax effects of the transaction and there was no discussion pertaining to taxes (R. 61, 78). All of the documents at issue were executed either in 1948 or in 1956; about fifteen years and seven years, respectively, before this tax case arose in 1963 (R. 89-114, 85).

Though conceding that Sullivan received neither money or property, the Court below concluded he had received income (Ct. of Appeals Opinion, p. 8).

REASONS FOR GRANTING THE WRIT

I.

Though Sullivan Received No Income from the Transaction, the Court Below Has Imposed an Income Tax in Violation of the Sixteenth Amendment and of the Fifth Amendment.

There is no dispute that Nelson received the money and that Sullivan received neither money or property. Accordingly, the question is whether, when a corporation buys the shares of one of its stockholders, and another stock-

holder was by contract bound to buy at book value,[3] has the corporation thereby made a distribution of anything to the remaining stockholder?

This question, however, raises the complex and subtle question of what is income.

The Court below (Opinion, p. 8) concluded that the financial worth of Sullivan's interest in the corporation was the same after the transaction as it was before. Before the transaction, Nelson owned two-fifths of the corporation, worth about $200,000.00; and Sullivan owned three-fifths of the corporation, worth about $300,000.00. Upon the partial liquidation and stock redemption, the corporation paid Nelson about $200,000.00. Thus the value of Sullivan's interest in the corporation after the transaction remained $300,000.00. Concededly, thus far the transaction resulted in no economic benefit (or income) to Sullivan.

However, the Court below found (Opinion, p. 8) that the transaction resulted in an economic benefit to Sullivan because he was relieved of a *personal obligation* to purchase Nelson's stock. Conceding *arguendo* that Sullivan had a *personal obligation* to purchase Nelson's stock, the assumption thereof by the corporation cannot constitute income to Sullivan. Sullivan's obligation was to buy an asset for an amount equal to its value. Had he done so—had he purchased Nelson's shares of stock—he would have exchanged cash in the amount of $200,000.00 for an asset worth $200,000.00. His net worth would have remained the same—consequently, his "obligation" was not a liability or debt. For example, if Sullivan had been obligated to purchase General Motors stock worth $200,000.00, assigned that contract to the corporation, and the corpora-

3. Assumed arguendo.

tion purchased the stock; no one would contend that Sullivan received income. The aforesaid transaction is identical to the transaction at issue herein. The corporation's purchase of Nelson's stock did not increase Sullivan's wealth—or satisfy a debt or liability—accordingly, he received no income. We respectfully submit that the contrary conclusion of the Court below is erroneous and raises the Constitutional questions at issue herein.

Benefit is "a pecuniary advantage or profit; [or] gain; * * *." *Black's Law Dictionary*, Fourth Edition, p. 200. However, not all economic gain is taxable income. *Helvering* v. *Horst*, 311 U.S. 112, 115 (1940).

"Income" is income as the word is known in common speech. *United States* v. *Safety Car Heating & Lighting Co.*, 297 U.S. 88, 99 (1936). "Income" is gain derived from capital, from labor, or from both combined, including profit gained through the sale or exchange of capital. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170, 174 (1926). "Income" means an undeniable accession to wealth, clearly realized. *Commissioner of Internal Revenue* v. *Glenshaw Glass Company*, 348 U.S. 426, 431 (1955). The phrase "accession to wealth" plainly means an increase in financial worth. From this transaction, Sullivan received no gain or profit and no increase to his wealth—and the opinion of the Court below admits this. It follows that he received no income.

Most simply stated, conceding *arguendo* that the corporation satisfied an obligation of Sullivan, there was no income to him because the corporation did not satisfy a debt or liability of Sullivan. "Debt" or "liability" is used in the sense of an obligation for which the taxpayer has received something of value—something which *increased* his wealth. As above, if *Sullivan* had purchased the Gen-

eral Motors stock, which the corporation paid for, he would have received income—an "accession to wealth"—since his financial worth would have been increased. Moreover, if a taxpayer borrows money from a bank, executing a promissory note therefor, which his corporation satisfies, he has received income since his net worth has been increased (by a reduction of his liabilities). He received and retained the money—the corporation paid his debt. Income, however, arises from none of the foregoing analogies solely because of the satisfaction of a personal obligation—but because the personal obligation was accompanied by the receipt of money or property, or the satisfaction of an obligation for which money or property was received.

The touchstone of income is gain or profit, received in the form of money or property, which increases the taxpayer's wealth. The Court below has admitted that Sullivan received no gain, in the form of money or property, which increased his wealth.

If Sullivan had received income from this transaction, he should be able to pay the tax due from such income. Demonstrably, he cannot. Assume that Sullivan had only the personal contract obligation and owned three-fifths of the corporation, worth $300,000.00, but owned no other assets. Nelson, of course, received the $200,000.00 taxed to Sullivan. After the stock redemption, Sullivan has the same shares of stock worth the same amount as before. He has no money or property with which to pay the tax (about $150,000.00) he owes on the transaction. Admittedly, the Government can levy on Sullivan's stock and collect the $150,000.00—but this is a seizure of his capital investment.

The finale of this tax tragedy demonstrates the error in the conclusion of the Court below. After the redemp-

tion, Nelson has $200,000.00 on which he pays tax; and Sullivan has the same stock interest worth $300,000.00. The $200,000.00 received by Nelson is *also* taxed to Sullivan on which he owes $150,000.00 and the Government collects the tax from Sullivan's stock interest. Sullivan is now left with stock worth only $150,000.00. He has not received a nickel but has lost half of his capital investment. This cannot be the law.

It is undisputed that the only "income" in this case is the $200,000.00 Nelson received from the corporation in exchange for his stock. Nelson received $200,000.00 in cash and paid a capital gains tax thereon. Sullivan, however—who admittedly received neither money or property—has had the same $200,000.00 taxed to him. The only distinction is that Sullivan has been taxed at ordinary income rates. Obviously, only the Government received economic benefit from this transaction.

Income cannot be created from the mere satisfaction of an executory obligation. The satisfaction must be accompanied by or related to the receipt of money or property. Otherwise, there is no "accession to wealth". Without an increase in wealth, there is no income. *Commissioner of Internal Revenue* v. *Glenshaw Glass Company, supra.*

The conflict between the trial court's opinion in this case, and revenue rulings acquiescing in cases turning on the question of economic benefit, has been noted by authorities in the tax field, 24 N.Y.U. 1229, 1235, 1236 ("New York University Twenty-Fourth Annual Institute on Federal Taxation") (1966), as follows:

> "Distinction Between Executory and Executed Contracts
>
> * * *

The acquiescences may be construed as reflecting the Service's position that a constructive dividend would not ensue from a corporation's performance of a shareholder's wholly executory contractual obligation to purchase the stock of another shareholder, provided that the purchase price was geared to fair market value."

(1235)

"Economic Benefit Theory

* * *

"Then along came the recent decision in Sullivan v. United States,[16] which rejected the very arguments (by the taxpayer) which the Service's prior acquiescences seemed to approve. The court refused to perceive any valid distinction between the discharge of a shareholder's debt and the performance of his executory contractual obligation. Moreover, the economic benefit to the shareholder was viewed not in the sense of net worth or the value of his interest in the corporation but quite literally as follows: 'The economic benefit to the plaintiff Sullivan in this case was the discharge by the corporation of his private obligation to purchase Nelson's stock with the use of corporate earnings.'

"The *Sullivan* case could make some interesting waves. If the Service intends to adhere to the position apparently signaled by its acquiescences to *Kobacker* and *Decker* it ought to do so clearly and affirmatively."

(1236)

The conclusion of the Court below that Sullivan received income is in square conflict with one of its prior decisions, with the decisions of other Courts of Appeal, with the decisions of the Tax Court of the United States, and with the Commissioner's own rulings on this question. In *Ruben* v. *Commissioner of Internal Revenue*, 97 F. 2d 926, 928 (C.C.A. 8th, 1938), the corporation of which Ruben

was a shareholder paid a compromised judgment binding upon the corporation and certain shareholders, including Ruben. There the Court recognized that the corporation had reduced its net worth by payment of the judgment, and that Ruben had received nothing since he received no economic benefit—even though he had been released from a *personal judgment* against him. In *Ruben*, the Court specifically found that there were no gains, profits, or "income" to the taxpayer.

The determination of the Court below that Sullivan received income is in square conflict, upon identical facts with *John A. Decker*, 32 T.C. 326 (1959), aff'd 286 F. 2d 427 (C.A. 6th, 1960). In *Decker* there was no dispute that the taxpayer was *unconditionally obligated* to purchase the stock and that the obligation was assumed by the corporation. The Tax Court, however, specifically found that the taxpayer received no income because he received no economic benefit from the transaction, stating that (p. 333):

> "While petitioners may have been *obligated* to purchase the stock of a deceased stockholder, this is a different sort of obligation from those in the *Wall*, *Ferro*, and other cases wherein this point has been raised. Petitioners' obligation here was to purchase stock for its book value. Presumably the stock was worth what was paid for it. Had petitioners bought and retained the stock, their net worths would have remained the same. The corporation did not pay a pre-existing *debt* of the petitioners, the satisfaction of which would increase their net worths. They realized no economic benefit from the transaction." (Emphasis added).

The determination of the Court below that Sullivan received income from this transaction is also in conflict with the substance of the decisions of other Courts of Appeals on this question. *Schmitt* v. *Commissioner of*

Internal Revenue, 208 F. 2d 819, 821 (C.A. 3rd, 1954); *Holsey* v. *Commissioner of Internal Revenue*, 258 F. 2d 865, 868 (C.A. 3rd, 1958); *Niederkrome* v. *C. I. R.*, 266 F. 2d 238, 243 (C.A. 9th, 1958). In *Holsey*, the Court stated that whatever benefits the majority stockholder enjoyed through acquisition by the corporation of the shares of another shareholder "could not give rise to taxable income within the meaning of the Sixteenth Amendment * * *". In *Niederkrome* the Court held that the "real question is whether the taxpayers received any financial or economic benefits as a result of the redemption * * *".

The Tax Court regularly determines that no dividend was received where the taxpayer's financial worth was not increased—even though the redeeming corporation discharged an unconditional contract obligation of the surviving shareholder to redeem another shareholder's stock. *John A. Decker, supra*, p. 333; *William A. Green*, T. C. Memo. 1963-248, 22 T.C.M. 1241, 1246 (1963); *John McShain*, T. C. Memo. 1963-306, 22 T.C.M. 1611, 1616 (1963); *Accord, William K. Edmister*, 46 T.C. ....., No. 67 (1966) (Where the distinction between cases resulting in income, and those wherein the taxpayers in reality received nothing, is clearly pointed out).

The Commissioner of Internal Revenue has ruled that there can be no constructive dividend unless the stock is in reality *purchased* by a remaining shareholder and paid for by the corporation—even though the corporation's redemption of stock relieved the remaining shareholder of a *personal obligation* to redeem said stock. Rev. Rul. 58-614, C.B. 1958-2, p. 920; Rev. Rul. 59-286, C.B. 1959-2, pp. 103, 105 (Appendix A, *infra*, p. A11). At page 2 of its Opinion the Court below determined that the *corporation* purchased the stock. Consequently, the Court's conclusion herein is in square conflict with the respondent's announced litigating position on this question. In support of the con-

clusion that Sullivan received income, the Court below relied on three cases cited on page 7 of its Opinion. None of said cases are relevant as demonstrated on pages 10 and 11 of Appellants' Petition for Rehearing. The Court below also relied extensively on *Idol* v. *C. I. R.*, 319 F. 2d 647 (C.A. 8th, 1963). That case is clearly distinguishable as urged on page 4 of Appellants' Renewed Petition for Rehearing. In each of the aforementioned cases, the taxpayer obviously received money or property—or the corporation satisfied a debt of the taxpayer for which money or property had been received. Accordingly, the conclusion of the Court below that Sullivan received income is unsupported by relevant case law.

This issue has been a prolific source of litigation for at least twenty years—literally scores of cases involving this question have been before the Courts. Those cases, however, do not include one—where a taxpayer received nothing more than the satisfaction of a personal obligation —wherein a Court concluded that the taxpayer received income. Even the Commissioner of Internal Revenue has ruled that "there is no authority affirmatively supporting the proposition that a redemption of one shareholder's shares, at fair market value, constitutes a dividend to the remaining shareholder". Rev. Rul. 59-286, *supra*, p. 105.

The conclusion of the Court below that petitioners received income is in direct conflict with the decisions of this Court construing the meaning of income within the Sixteenth Amendment. *Eisner* v. *Macomber*, 252 U.S. 189, 206, 207 (1920); *Edwards* v. *Cuba R. Co.*, 268 U.S. 628, 631 (1925); *U.S.* v. *Safety Car Heating & Lighting Co., supra; Bowers* v. *Kerbaugh-Empire Co., supra; Commissioner of Internal Revenue* v. *Glenshaw Glass Company, supra.*

Since petitioners received no income, to impose a tax is in violation of the Sixteenth Amendment; and is also in

violation of the Fifth Amendment, since they have been deprived of their property without due process of law.

II.

In a Federal Tax Case the Substance and Reality of the Transaction Is Controlling, the Courts Should Consider Motives, Intent, and Conduct in Addition to Written Instruments; Consequently, the Decision of the Court Below Admittedly Exalting Form Over Substance Is in Conflict with the Decisions of This Court and with the Decisions of Other Courts of Appeals.

On trial, five witnesses testified, without contradiction, on behalf of petitioners. This testimony was supported by substantial documentary evidence, which had been executed many years prior to the initiation of this case. The aforesaid evidence established that when the contract was executed in September, 1948, the parties intended that the corporation would be obligated to redeem Nelson's stock (by reason of its ratification and adoption of the contract); and that it was never intended that Sullivan would be personally obligated to redeem said stock. The trial court adopted the findings of fact set forth in petitioners' briefs practically verbatim and concluded that the oral evidence supported petitioners' factual contentions—but could not be considered because of the parol evidence rule. *Sullivan* v. *United States*, 244 F. Supp. 605, 615 (D.C. Mo., 1965) (Appendix B, *infra*, p. A16).

The substance of the transaction is clear. If Nelson left the corporation, the contract provided Sullivan the right to direct the sale of Nelson's stock to the manager who replaced him. Since Nelson could not be replaced, the corporation liquidated the automobile dealership, continued as a finance company, and redeemed Nelson's stock. The contract gave Sullivan an option—buy the stock, or direct its sale to a third party. Here the third party was

the corporation—thus this transaction is identical to that in *Holsey* v. *Commissioner of Internal Revenue, supra,* pp. 866, 868; *S. K. Ames, Inc.,* 46 B.T.A. 1020, 1023-1024 (1942) (Acq., C.B. 1942-1, p. 1); *Fred F. Fischer,* Memo. Op., Docket No. 8737, 6 T.C.M. 520, 525 (1947); *Benjamin H. Freeman,* 41 T.C. 379, 384 (1963). The Commissioner of Internal Revenue has followed *Holsey* and *Ames* in ruling that where the contract obligation was an option, or was conditional—no dividend resulted from its assumption by the corporation. Rev. Rul. 59-286, *supra,* p. 105. In the Court below the Government admitted on brief that the contract obligation herein was conditional (Appellee's Brief, pp. 16, 23).

On page 9 of its Opinion, the Court of Appeals herein recognized that its determination exalted form over substance. In tax cases, the substance and reality of the transaction is controlling, formal written documents are not rigidly binding, and Courts should consider motives, intent, and conduct in addition to written instruments. *United States* v. *Phellis,* 257 U.S. 156, 168 (1921); *Weiss* v. *Stearn,* 265 U.S. 242, 254 (1924); *Bowers* v. *Kerbaugh-Empire Co., supra,* p. 174; *Helvering* v. *F. & R. Lazarus & Co.,* 308 U.S. 252, 255 (1939); *Commissioner of Internal Revenue* v. *Court Holding Co.,* 324 U.S. 881, 884 (1945); *United States* v. *Cumberland Public Service Co.,* 338 U.S. 451, 454, fn. 3 (1950); *C. I. R.* v. *Hansen,* 360 U.S. 446, 461 (1959). Consequently, the decision of the Court below is in square conflict with the decisions of this Court on this principle.

On this principle, the decision of the Court below is also in square conflict with its holdings in other cases. *Helvering* v. *Killian Co.,* 128 F. 2d 433, 434 (C.C.A. 8th, 1942); *Boykin* v. *Commissioner of Internal Revenue,* 260 F. 2d 249, 254 (C.A. 8th, 1958); *Western Contracting Corporation* v. *C. I. R.,* 271 F. 2d 694, 699 (C.A. 8th, 1959).

Moreover, the determination of the Court below on this question is in square conflict with the decisions of other Courts of Appeals. *Fox* v. *Harrison*, 145 F. 2d 521, 522 (C.C.A. 7th, 1944); *Landa* v. *Commissioner of Internal Revenue*, 206 F. 2d 431, 432 (C.A., D.C., 1953); *Lacy* v. *C. I. R.*, 341 F. 2d 54, 57 (C.A. 10th, 1965) (Where the Court stated that "Although the ambiguity of the contract may be arguable, we are convinced that parol testimony was admissible to explain the intent and motives of the parties. In no other way may substance be separated from form"); *R. C. Owen Company* v. *C. I. R.*, 351 F. 2d 410, 414 (C.A. 6th, 1965); *Foxman* v. *C. I. R.*, 352 F. 2d 466, 469 (C.A. 3rd, 1965); *Kinney* v. *United States*, 358 F. 2d 738, 739 (C.A. 5th, 1966); *Blueberry Land Company* v. *C. I. R.*, 361 F. 2d 93, 101 (C.A. 5th, 1966).

The determination of the Court below is in square conflict with the rule followed by the Court of Claims. *Affiliated Research, Inc.* v. *United States*, 351 F. 2d 646, 648 (Ct. Clms., 1965).

The decision of the Court below is also in square conflict with decisions of the Tax Court extending over at least a twenty-year period. *Charles F. Mitchell*, 45 B.T.A. 300, 303 (1941); *Penn Athletic Club Building*, 10 T.C. 919, 939 (1948); *Sarah Helen Harrison*, 17 T.C. 1350, 1357 (1952); *Rupe Investment Corporation*, 30 T.C. 240, 251 (1958); *Estate of Leon Holtz*, 38 T.C. 37, 41 (1962); *Walter Lacy*, 39 T.C. 1100, 1104 (1963).

The error of the Courts below on the question of substance versus form was compelled by their erroneous conclusion on the parol evidence rule. Only Sullivan, Nelson, and the corporation were parties to the contract. The respondent was not a party to the contract, or in privity with a party thereto. The parol evidence rule cannot be

invoked by the respondent herein because the principle is clear that the parol evidence rule cannot be invoked either by or against a stranger to the contract. *Miller* v. *Robertson*, 266 U.S. 243, 255 (1924); *Birmingham* v. *Bartels*, 157 F. 2d 295, 301 (C.C.A. 8th, 1946), rev'd other grounds, 332 U.S. 126 (1947); *Reynolds* v. *Boos*, 188 F. 2d 322, 324 (C.A. 8th, 1951); *Johnson Farm Equipment Company* v. *Cook*, 230 F. 2d 119, 125 (C.A. 8th, 1956). The conclusion of both Courts below to the contrary is in square conflict with the decisions of this Court and with the decisions of the Court of Appeals for the Eighth Circuit. In *Birmingham* v. *Bartels*, this Court's reversal of the Eighth Circuit left this Court's determination supported solely by the parol evidence admitted in the trial court. In *Reynolds* v. *Boos* the Court below analyzed the Supreme Court's opinion in *Birmingham* v. *Bartels* and concluded that the Supreme Court's determination therein supported its admission of parol evidence in a tax case where the Government was not a party to the disputed agreement. However, the Court below did not follow, overrule, or distinguish its own prior decisions on this question—which plainly support petitioners.

The principle that a stranger to the contract may not invoke the parol evidence rule is followed by virtually every United States Court of Appeals. *Stern* v. *Commissioner*, 137 F. 2d 43, 46 (C.C.A. 2nd, 1943); *Brassert* v. *Clark*, 162 F. 2d 967, 973 (C.C.A. 2nd, 1947); *Commissioner of Int. Rev.* v. *Penn Athletic Club Building*, 176 F. 2d 939, 944 (C.A. 3rd, 1949); *Patterson* v. *Texas Co.*, 131 F. 2d 998, 1001 (C.C.A. 5th, 1943); *Scofield* v. *Greer*, 185 F. 2d 551, 552 (C.A. 5th, 1950); *Scott* v. *Gearner*, 197 F. 2d 93, 96 (C.A. 5th, 1952); *Commissioner of Internal Revenue* v. *Gibbs-Preyer Trust Nos. 1 and 2*, 117 F. 2d 619, 622 (C.C.A. 6th, 1941); *Borin Corporation* v. *Commissioner of*

Internal Revenue, 117 F. 2d 917, 920 (C.C.A. 6th, 1941), cert. den. 314 U.S. 638; *Essington* v. *Parish*, 164 F. 2d 725, 729 (C.C.A. 7th, 1947); *Thorsness* v. *United States*, 260 F. 2d 341, 345 (C.A. 7th, 1958); *Worcester Felt Pad Corp.* v. *Tucson Airport Authority*, 233 F. 2d 44, 51 (C.A. 9th, 1956); *Smith* v. *C. I. R.*, 324 F. 2d 725, 726 (C.A. 9th, 1963); *American Crystal Sugar Co.* v. *Nicholas*, 124 F. 2d 477, 479 (C.C.A. 10th, 1941); *Bardwell* v. *C. I. R.*, 318 F. 2d 786, 790 (C.A. 10th, 1963); *Landa* v. *Commissioner of Internal Revenue, supra*, p. 432; *Gibson* v. *United States*, 268 F. 2d 586, 589 (C.A., D.C., 1959). This principle is also followed by the Court of Claims. *Mustard* v. *United States*, 155 F. Supp. 325, 332 (Ct. Clms., 1957). Since most of the cases cited are Federal tax cases, the rule is universally followed in tax cases involving either the United States or the Commissioner of Internal Revenue as a party. The holding of the Court below on this question is in square conflict with the aforesaid decisions of the Courts of Appeals and the Court of Claims.

The Tax Court of the United States (formerly the Board of Tax Appeals), has followed the foregoing principle since its creation in 1925, through the intervening years up to the present time. *Converse & Co.*, 1 B.T.A. 742, 745 (1925); *J. W. Solof*, 1 B.T.A. 776, 785 (1925); *Arthur B. Grover*, 3 B.T.A. 508, 513 (1926); *The Amalgamated Sugar Co.*, 4 B.T.A. 568, 575 (1926); *Stratton Grocery Co.*, 8 B.T.A. 317, 322 (1927); *James D. Boone*, 27 B.T.A. 1064, 1067 (1933); *United National Corporation*, 33 B.T.A. 790, 798 (1935); *Macon, Dublin & Savannah Railroad Co.*, 40 B.T.A. 1266, 1271 (1939); *Combs Lumber Co.*, 41 B.T.A. 339, 342 (1940); *Charles F. Mitchell, supra*, p. 303; *Haverty Realty & Investment Co.*, 3 T.C. 161, 167 (1944); *Penn Athletic Club Building, supra*, p. 938; *Sarah Helen Harrison, supra*, p. 1357; *Estate of Leon Holtz, supra*,

p. 41; *Elizabeth H. Bardwell*, 38 T.C. 84, 90 (Fn. 2) (1962); *Walter Lacy, supra*, p. 1104; *Clifford H. Wren*, T.C. Memo. 1965-52, 24 T.C.M. 290, 294 (1965). The Tax Court, which is concerned almost entirely with cases involving Federal taxation, has universally applied this majority rule. Research has failed to disclose a single Tax Court case to the contrary.

Our system of income taxation is national in scope, and contemplates the uniform treatment of taxpayers. No citizen should be required to bear more than his share of the burden, or sustain a litigating loss, by reason of a radical departure from the prevailing view on an evidence question. Precisely that result, however, has been reached in the Court below. A tax exceeding $200,000.00 (including interest and costs), has been adjudged against petitioners solely because of the Court's ruling on the parol evidence question. The facts are undisputed. As stated above, the trial court conceded that the oral evidence supports the factual contentions of petitioners—but accorded that evidence no legal effect because of its holding on the parol evidence question.

The Court's holding on this principle will have a far-reaching effect on tax litigation throughout the Nation. Accordingly, the lower Courts and tax litigants must be apprised of which principle prevails—*Sullivan* v. *United States* or the decisions of this Court, prior decisions of the Eighth Circuit, the decisions of the other Courts of Appeals, of the Court of Claims, and the Tax Court.

The taxpayer, as well as the Government, is entitled to the benefit of the substance versus form rule. *C.I.R.* v. *Hansen, supra*, p. 461; *Landa* v. *Commissioner of Internal Revenue, supra*, p. 432. Accordingly, the Court's holding on the parol evidence question is of no lasting

comfort to the Government. If this rule bars a taxpayer from establishing the substance and reality of a transaction—it also bars the Government. Consequently, henceforth, taxation will turn on mere form, and any artificial and contrived sham will control—so long as it is reflected in a written document. If the conclusion of the Court below on this question is permitted to stand, reality will be lost to the administration of the Revenue Laws. Fiction will prevail.

III.

Since the Subject Transaction Also Constituted a Partial Liquidation of the Corporation, There Could Not Be a Dividend to Sullivan by Reason of the Explicit Provisions of Sections 346 (b) and 331; Consequently, the Refusal of the Court Below to Pass on This Issue So Departs from the Accepted Course of Judicial Proceedings As to Require This Court's Supervision.

In each of the Courts below petitioners urged that, by reason of Congressional intent in enacting the foregoing statutes, and the literal language thereof, there could not be a dividend to Sullivan. At least the trial court passed on this question—holding that Section 346 was not intended to apply to a situation such as is involved here. *Sullivan* v. *United States, supra,* p. 624. (As will be seen hereinafter, however, this conclusion is in square conflict with the opinion of the Court of Appeals for the Eighth Circuit in *United States* v. *Carey,* 289 F. 2d 531, 536 (C.A. 8th, 1961).)

Though argued on principal and reply brief by petitioners in the Court of Appeals, and urged on the original and renewed Petitions for Rehearing, the Opinion of the Court below contains no reference whatsoever to this issue. The failure of the Court of Appeals to pass on this question is aggravated by its recognition in *Carey* that this question

was relevant to the issue of a constructive dividend, and by the Court's construction of Section 346 in *Carey* which plainly supports petitioners herein.

There is no dispute on the facts which satisfy the objective requirements of Section 346 (b). The redemption was attributable to Nelson's resignation and the corporation's ceasing to conduct the Chevrolet business (R. 101, 102, 172, 173, 39). The Chevrolet business had been conducted for the five-year period immediately before the distribution, since it was incorporated soon after Sullivan acquired the dealership in 1941 (R. 19, 85). The finance business had also been conducted for more than five years since expansion of that department was commenced in the latter part of 1948 (R. 27). After the distribution the corporation continued in the finance business and was so engaged at the time of trial (R. 33). Finally, since the finance business was initiated sometime prior to 1948, it was not acquired by the corporation within the five-year period preceding the distribution in a transaction in which gain or loss was recognized (R. 27). Thus each of the objective requirements of Section 346 (b) are met—clearly, there was a termination of a business and a contraction of the corporation which constitutes a partial liquidation under Section 346 (b).

Under Section 115 of the 1939 Code, the only criteria was whether the transaction was "essentially equivalent to a dividend". In viewing a transaction involving this question from the shareholder level and the corporate level, the courts struggled with this one concept for years.[4] Over the years the courts developed two overriding criteria in

4. Discussions of this historical confusion and Congressional attempts to eliminate it by enactment of the 1954 Code appear in: 10 Tax Law Review 213 (1954), and 103 Pennsylvania Law Review 936 (1955).

determining whether there was dividend equivalency under Section 115. The first test, applied at the shareholder level, was whether there had been a termination or significant reduction in the interest of the stockholder in the corporation. The second test, which viewed the transaction from the corporate level, was whether there had been a contraction or partial liquidation of the corporation. *United States* v. *Carey, supra,* p. 534; *Sorem* v. *C. I. R.,* 334 F. 2d 275, 279-280 (C.A. 10th, 1964).[5] Congress recognized these two criteria in the enactment of the 1954 Code. Congress incorporated the first concept in Section 302 of the 1954 Code; and the second in Section 346 of the 1954 Code. Congress intentionally segregated the two concepts under separate provisions of the Code in order to sharpen the distinction between them. *United States* v. *Carey, supra,* p. 535; *McCarthy* v. *Conley,* 341 F. 2d 948, 951 (C.A. 2nd, 1965); The Law of Federal Income Taxation (Mertens), Vol. I (Zimet Ed.), Sec. 9.70, p. 134; Code Commentary (Mertens), Section 346, p. 178.

Moreover, in Section 346 (b), Congress went a step further. If a transaction constitutes a partial liquidation under Subsection (b) of Section 346 the question of dividend equivalency is not applicable. In other words, transactions falling within the provisions of Section 346 (b) are *by statute* "not essentially equivalent to a dividend". Section 346 (b); S. Rep. No. 1622, 83rd Cong., 2nd Sess., 3 U.S. Code Cong. and Adm. News (1954), p. 4900; *United States* v. *Carey, supra,* p. 536; *McCarthy* v. *Conley, supra,* p. 955. In *Carey* the Court below specifically held that "Subsection 346 (b) sets out a specific type of distribution

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5. In the case at bar, the transaction satisfied both criteria —all of Nelson's stock was redeemed; and there was a contraction and partial liquidation of the corporation. Thus, even under the 1939 Code and the case law based thereon, there was no constructive dividend to Sullivan. *Sorem* v. *C. I. R., supra,* p. 279.

involving the termination of a business activity conducted for five years which will constitute a liquidation *not equivalent to a dividend*"[6] (Emphasis added). However, in *Carey*, since the Court below affirmed the trial court's holding that the stock redemption was not essentially equivalent to a dividend under Section 302, the Court concluded (Opinion, p. 536), that it was unnecessary to determine the question of what constitutes a partial liquidation under Section 346. The question was moot in *Carey*. Obviously, it is not moot in this case.

Petitioners submit that in *Carey* the Court below specifically recognized the applicability of Section 346 to the question of dividend equivalency—the only issue in that case. On the authority of *Carey*, petitioners respectfully contend that the Court below should have ruled on the effect of Section 346 (b) on the dividend issue herein. The substance of the transaction at issue in *Carey* and in the instant case is the same: a corporation redeemed the shares of a departing shareholder and the remaining shareholder was charged with the receipt of a dividend. In *Carey*, though the remaining shareholder received property from the corporation, the Court below concluded he received a capital gain. In the case at bar, though Sullivan admittedly received neither money or property—the same Court concluded he received ordinary income. Obviously, Congress did not intend such results.

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6. This result follows because of the statutory arrangement of Section 346 (a) and (b). Section 346 (a) (2) contains the phrase "not essentially equivalent to a dividend"—consequently a transaction under Section 346 (a) (2) must meet this test. This test, however, is not contained in Section 346 (b). To the contrary, Section 346 (b) plainly states that if a transaction falls under its provisions, "a distribution shall be treated as a *distribution described* in Subsection (a) (2)" (Emphasis added). The distribution "described" in Section 346 (a) (2) is one "not essentially equivalent to a dividend".

Finally, since distributions under Section 346 are governed by Section 331, and the latter section (and the regulations under that Section (Appendix A, *infra*, p. A11) specifically hold that Section 301 (governing dividend distributions), is not applicable—there can be no dividend to anyone in the instant case. Moreover, if a distribution (as here) falls within both Sections 302 and 346, only the latter provision is applicable. Section 346 (c); Regulations Sec. 1.346-2; Code Commentary (Mertens), Section 346 (c): 1, p. 183.

At page 6 of its Opinion the Court below—in stating the basic questions at issue in this case—relied on both Sections 301 and 302 of the 1954 Code. Since the subject stock redemption also constitutes a partial liquidation under Section 346 (b)—as a matter of law—neither Section 301 nor 302 is applicable. (As contended above, this is the precise result Congress intended by enactment of Section 302 and Section 346.) Accordingly, the determination of the Court below is without statutory support.

The question presented is solely a question of law, and is dispositive of the only issue in this case. Again, in *Carey*, the Court below specifically recognized the applicability of Section 346 (b) to the constructive dividend question—the only issue herein. Furthermore, though repeatedly brought to its attention, the Court below refused to pass on this question.

The Court's refusal to decide this question constitutes a radical departure from the accepted course of judicial proceedings which requires this Court's supervision.

If the determination of the Court below is allowed to stand a rank injustice will have been done to petitioners. Moreover, the intent of Congress in enacting the subject statutes (to eliminate confusion) will have been completely

frustrated. The law will remain as confused as it has been for forty years.[7]

IV.

Conclusion.

For the reason stated, it is respectfully submitted that this Petition for Certiorari should be granted.

Respectfully submitted,

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7. Legal periodicals invariably stress the confusion in this area of the tax law, e.g.:

"The Dividend Equivalence Test: Forty Years of Confusion," 43 Texas Law Review 755 (No. 5), (April 1965).

Murphy, "Dividend Equivalency—the End of the Beginning," 10 Tax Law Review 213 (1954). The first sentence reads: "Nowhere in the field of federal income taxation has there been an area so rife with confusion or so ripe for reform as that surrounding Section 115 (g) of the 1939 Code."

Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax Law Review 225 (1959).

Schlossberg, "Confusion Between Partial Liquidations and Redemptions Often Clouds Tax Planning," 22 The Journal of Taxation 152 (March 1965).